No. 16395

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

J. I. MORGAN AND FRANCES MORGAN, RESPONDENTS

On Petition for Review of the Decisions of the Tax Court of the United States

REPLY BRIEF FOR THE PETITIONER

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The brief for the taxpayer does not come to grips with the issue in the case concerning the meaning of Section 117(f) of the 1939 Code and the corresponding provision of Section 1232(a)(1) of the 1954 Code. The Commissioner's position is based on the proposition that, if the taxpayer had sold or exchanged the investment certificates, the portion of the amounts received representing the yearly increments in cash value over the amounts paid in would be taxable as ordinary income. Section 117(f) simply applies the same treatment to a retirement of the indebtedness. The taxpayer's brief does not directly deny this basic proposition as to treatment of accrued

ordinary income upon a sale or exchange, but reiterates his contention that Section 117(f) requires that all of the amounts received on retirement must be treated as capital gain, regardless of their treatment on an exchange. But under Point IV of his brief (pp. 19-21) taxpayer asserts that there is no evidence in the record that the increment in the certificate is accruable as interest. On the contrary, it is decisively settled that the increment is ordinary interest income and that it accrues each year.

As to the fact that the increment is ordinary interest income, it is clear from the face of the certificate that the difference between the amount paid for the investment certificate and the annual increment is the original discount of a non-interest bearing obligation. It has been settled since 1918, by decisions of this and other courts and Treasury Regulations, that such original discount is interest. *Gt. W. Power Co.* v. *California*, 297 U.S. 543; *San Joaquin Light & Power Corp.* v. *McLaughlin*, 65 F. 2d 677 (C.A. 9th); *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. 2d 695, 697 (C.A. 4th); G.C.M. 21890, 1940-1 Cum. Bull. 85.[1] As taxpayer's chief reliance, *Commissioner* v. *Caulkins*, 144 F. (2) 482

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[1] The above decisions hold that original discount on interest-bearing obligations is an additional interest charge deductible as such by the debtor corporation. *A fortiori*, original discount on a non-interest bearing obligation takes the place of interest and is the interest. The article cited by the taxpayer, Janin, The Israeli Bond Ruling: Legislation By Administrative Fiat? 33 Taxes—The Tax Magazine, 191 (1955), ignores these decisions and is thus basically wrong. Rul. 119, 1953-2 Cum. Bull. 95, cited in our main brief (p. 18), is entirely sound.

(C.A. 6th) itself points out (p. 484) with respect to a like certificate, the increment in value of the certificate is compensation for the use of the money paid in, and, thus, is interest and it is immaterial that the contract does not provide for equal amounts of interest to be set aside each year.

It is equally settled that the annual increment of a non-interest bearing indebtedness representing payments of the original discount accrue each year to an accrual-basis taxpayer, the taxpayer here. (R. 7.) Such accrual is clearly indicated by express provisions of Section 42(b) of the 1939 Code, re-enacted by Section 454(a) of the 1954 Code. This section expressly authorizes a cash basis taxpayer to accrue the annual increment of an original discount on a non-interest bearing obligation redeemable for fixed amounts increasing at stated intervals exactly the type of obligation involved here.[2] The Committee

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[2] Section 42(b) of the Internal Revenue Code of 1939 reads in relevant part as follows:

> SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.
>
> * * * *
>
> (b) [As added by Section 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687, and amended by Sec. 2 of the Act of March 26, 1951, c. 19, 65 Stat. 26]. *Non-interest-bearing Obligations Issued at Discount.* If in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net income) constitute income to him in such year, such tax-

Reports on Section 42(b) disclose that the section is intended to give a cash basis taxpayer the privilege of reporting the annual increment as if he were an accrual-basis taxpayer, who is required to do so. Thus the House and Senate Committee Reports state as follows (H. Rep. No. 1040, 77th Cong. 1st Sess., pp. 40-41 (1941-2 Cum. Bull. 413, 445); S. Rep. No. 673, Part I, *idem*, p. 29 (1941-2 Cum. Bull. 466, 490)):

> This section provides that any taxpayer who owns any non-interest bearing obligations issued at a discount and redeemable for fixed amounts increasing at stated intervals and who, under the method of accounting used by him in computing his net income, is not permitted to report the increment in value of such obligations as it accrues, may, at his election, treat such increment in value as constituting income to him in the year in which it accrues rather than in the year in which the obligations are disposed of, redeemed, or paid at maturity. Under existing law a taxpayer on the accrual basis who owns, for example, non-interest bearing United States defense bonds is required to report the increment as it accrues, whereas a taxpayer on the cash basis who owns such defense bonds is required to treat the entire increment in value as being income received in the year of redemption

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payer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. * * *

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(26 U. S. C. 1952 ed., Sec. 42.)

> or maturity. Therefore, with respect to such non-interest bearing United States defense bonds, the effect of this section is to extend, at the election of the taxpayer, the accrual method to a taxpayer on the cash basis, but only for the limited purpose of reporting the increment in value of such bonds as it accrues.

* * * *

The taxpayer has, therefore, completely failed to rebut the proposition that the annual increment of the investment certificates in the case at bar represents ordinary interest income, is includible as it accrues annually in the income of an accrual-basis taxpayer, and is taxable as ordinary income if received on a sale or exchange. The taxpayer's failure to rebut this basic proposition undermines much of the argument in his brief. Taxpayer's major reliance is upon *Commissioner* v. *Caulkins*, *supra* (in its opening and Point I of the argument, Br. 6-13) but he begs the issue in that he fails to show whether *Caulkins* was correctly decided and should be followed. The Commissioner here is not attempting to limit the statutory language of Section 117(f) to the "capital" element (cf. Br. 11) but is rather contending that Section 117(f) merely provides that all amounts received upon retirement should be treated the same as if all the amounts were received upon exchange. Hence *McLain* v. *Commissioner*, 311 U.S. 527, and *Commissioner* v. *Winslow*, 113 F. 2d 418 (C.A. 1st), cited by the taxpayer (Br. 12) are not to the contrary. *Commissioner* v. *Carman*, 189 F. 2d 363 (C.A. 2d), and *Pierce Corp.* v. *Commissioner*, 120 F. 2d 206 (C.A. 5th), are not in point, since

they dealt with a purchase of an indebtedness for a single price, or "flat", including both the amount of the principal and interest accrued prior to the purchase. Such accrued interest is not interest to the purchaser of an obligation in default as to interest but simply a cost of the indebtedness to him. The distinction, so far as it affects the problem in the case at bar, was recognized in *Estate of Rickaby* v. *Commissioner*, 27 T. C. 886. This Court's decision in *Lurie* v. *Commissioner*, 156 F. 2d 436, did not involve the issue at bar, although it may be noted that in *Lurie* the taxpayer was claiming capital gain only on payments for principal. See 4 T. C. 1065, 1067.

The taxpayer's discussion of the historical background of Section 117(f) in Point II of his brief (pp. 13-16) likewise fails to meet the issue in this case. Each of the cited rulings was confined exclusively to the question of whether a retirement of an indebtedness was a sale or exchange. See *United States* v. *Fairbanks*, 95 F. 2d 795 (C.A. 9th), affirmed, 306 U.S. 436. In none of them is there any reference to treatment of original discount or interest upon retirement of a bond.[3]

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[3] In I.T. 1637, II-1 Cum. Bull. 36 (1923) no specific amounts are stated. *Werner* v. *Commissioner*, 15 B.T.A. 482 did not involve noninterest-bearing bonds and there is no statement in the facts as to whether the discount was original discount. I.T. 2488, VIII-2 Cum. Bull. 127 (1929) similarly does not mention any problem of interest and *Watson* v. *Commissioner*, 27 B.T.A. 463 (1932) involved a purchase of liberty bonds at a premium. None of the decisions affect the settled rulings, *supra*, that original discount is a form of interest.

In Point III of his brief (pp. 17-19), the taxpayer refers to 1939 Code, Section 115(c) and 1954 Code, Section 1241. Neither reference advances his argument that a provision for the treatment of amounts received in a transaction the same as if received in an exchange converts *all* amounts received in the transaction into capital gain. In each case, the liquidation of a corporation under Section 115(c) or surrender of a franchise under Section 1241, all that the statute provides is that capital gain shall be recognized to the same extent, and no more, as upon an exchange of stock or a franchise. That is exactly the meaning of Section 117(f). Under Section 115(c), a liquidation of a corporation involving the receipt of undistributed earnings and profits, results in capital gain only because the exchange of stock, at a price reflecting undistributed earnings and profits, results in capital gain. Additionally, it may be noted that a share of stock does not carry a right to receive income unless and until a dividend is declared; unlike the situation in cases illustrating the basic rule such as *Snow* or *Fisher*, no right to receive ordinary income out of the assets of the corporation accrues until the declaration of a dividend. (See Section 115(g) where a corporation cancels or redeems stock in a manner essentially equivalent to the distribution of a dividend). If a surrender of a franchise under Section 1241 also involved the transfer of accounts receivable, there is no doubt that the portion of the amounts received representing this item would be taxable as ordinary income, precisely because it

would be so taxed if received in an exchange of the franchise together with accounts receivable. *United States* v. *Snow*, 223 F. 2d 103 (C.A. 9th).

We have already dealt with the taxpayer's Point IV. The taxpayer's contention in Point V (pp. 21-27) that the 1954 Code changed the prior law to provide for ordinary income treatment of original discount, and only for instruments issued after December 31, 1954, rests upon several fallacies. *First*, it is not true that *Caulkins* was unquestioned before the enactment of the 1954 Code. As pointed out in our main brief (p. 18) the Commissioner had, prior to 1954, rejected *Caulkins* by confining it to its facts and ruling that the original discount on Israeli bonds was ordinary income whether payable in cash at intervals or at maturity. Rev. Rul. 119, 1953-2 Cum. Bull. 95. *Second*, the taxpayer's contention is also squarely contradicted by the Senate Committee Report, quoted at page 20, footnote 7 of our main brief. The taxpayer's reliance upon a single phrase in the Report of the House Committee (Br. 22) is misplaced, since the Senate Committee Report is a later and more precise statement, disclosing that the 1954 Code was intended to remove the doubt caused by the *Caulkins* decision, rather than to change the existing law.

The taxpayer's further contention (p. 25) in Point V, that by Section 1232(a)(2) Congress intended that the gain from the exchange or retirement of an obligation issued after March 1, 1954, should accrue only upon the disposition of the instrument, is errone-

ous. Section 1232(a)(2)(C)[4] makes it clear that these provisions regarding the reporting of original discount received at maturity are subject to the annual accrual of increases of cash value to an accrual basis taxpayer or a cash basis taxpayer who has elected to use the accrual basis to report this income prior to maturity. The taxpayer has omitted from his quotation of the relevant Treasury Regulations, the express proviso that any amounts of annual increments of original discount "previously includible" in a taxpayer's income are "not again includible in his gross income under Section 1232." Treasury Regulations on Capital Gains and Losses (1954 Code), Sec. 1.1232-3(e).

The same observation applies to 1954 Code Section 72(e) and (l) referred to by the taxpayer. (Br. 27.) These sections provide that the three year spread for reporting the receipt of taxable proceeds of an endowment contract shall apply to face-amount certificates. But this provision does not qualify the provisions for annual accrual of original discount

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[4] Section 1232(C) of the 1954 Code reads as follows:

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

* * * *

(C) *Election as to inclusion.*—In the case of obligations with respect to which the taxpayer has made an election provided by section 454(a) and (c) (relating to accounting rules for certain obligations issued at a discount), this section shall not require the inclusion of any amount previously includible in gross income.

* * * *

(26 U. S. C. 1952 ed., Sec. 1232.)

of face-amount certificates, where the certificate, as here, is redeemable in fixed amounts of cash increasing at stated intervals, prior to maturity.

Finally, the taxpayer's attempt (Br. 28-30) to distinguish the main cases relied upon by the Commissioner fails, because the taxpayer has failed to meet the basic underlying proposition, for which these cases stand—that amounts representing ordinary income received upon the sale or exchange of a capital asset are taxable as ordinary income. It follows from this proposition that Section 117(f) simply means that such amounts shall be treated the same when received upon retirement, and that Section 117(f) does not convert this income into capital gain if received upon retirement, as contended by the taxpayer.

It is of no consequence that the Commissioner has chosen to relitigate the issue in the case at bar rather than in other cases where the Tax Court has followed the contrary *Caulkins* rule. As pointed out in our main brief (pp. 17-18), the Commissioner's contention that *Caulkins* was incorrect, and his intention to seek a judicial construction of Section 117(f), in

accord with the views advanced in this case, was long foreshadowed.

Respectfully submitted,

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